



Kansas Legislative Research Department

Providing nonpartisan, objective research and fiscal analysis for the Kansas Legislature since 1934

68-West-Statehouse | 300 SW 10th Ave. | Topeka, Kansas 66612-1504
(785) 296-3181

kslegres@klrd.ks.gov

kslegislature.org/klrd

December 19, 2019

TOBACCO SETTLEMENT UPDATE

Master Settlement Agreement

In 1998, Kansas became 1 of 46 states to accept a tobacco settlement negotiated with 4 major tobacco companies. (*Note:* The remaining four states settled individually.) The settlement, called the Master Settlement Agreement, was aimed at reducing the use of tobacco by young persons, settling legal claims by states against the tobacco industry, and providing reimbursement for health care costs of treating Medicaid patients whose illnesses were caused by tobacco. Under terms of the agreement, the tobacco industry is prohibited from targeting youth in marketing and is subject to restrictions concerning sponsorships, advertising, and tobacco promotions.

Each state and territory receives the proportion of the settlement that its smoking-related health care costs bear to the total. The allocation formula is based on each state's smoking-related health care costs, with equal weight given to Medicaid-related and non-Medicaid-related costs. Kansas' share of the recovery is 0.83 percent, which, based on the original estimate, was expected to exceed \$1.5 billion over the first 25 years of the agreement. Payments are based on the tobacco companies' market share of tobacco product sales and are subject to an annual inflation factor of 3.0 percent, or the increase in the Consumer Price Index, whichever is greater.

The Master Settlement Agreement also provides that payments to states could be reduced if tobacco sales go down or if tobacco companies go out of business. It is this latter provision that causes concern over future payments.

The tobacco industry is required to make payments to the states in perpetuity. Original estimates were that the industry would pay states \$206.0 billion through the year 2025. Not all tobacco companies are party to the settlement. Those that are not are required to put into escrow an amount of money equal to what they would pay under the settlement. This is to level the playing field so nonparticipating manufacturers will not have a competitive advantage over participating manufacturers.

Arbitration

Under the Master Settlement Agreement, companies are allowed to make payments into a disputed payments account, and those funds are held until a legal resolution is reached regarding those payments. In December 2012, through an arbitrated "settlement in principal," Kansas agreed to receive 54.0 percent, approximately \$46.0 million, of the money remaining in the disputed payments account, and the tobacco manufacturers received the other 46.0 percent of the money. The arbitration panel found the "settlement in principal" to be sufficient and issued an award to that effect. Final agreement on the settlement was reached in November 2017.

Kansas' liability for past allegations of failure to diligently enforce its obligation were eliminated with the final settlement for enforcement years 2003 to 2015.

Tobacco Payments to Kansas

Kansas received its first tobacco revenues in 1999. In general, payments have been less than originally estimated. Tobacco revenues and interest earnings totaled \$57.6 million in FY 2018 and \$56.0 million in FY 2019. Revenues are estimated to be \$52.0 million in FY 2020 and \$50.0 million in FY 2021.

It is important to note, beginning in FY 2008, revenues include funds from the “Strategic Contribution Fund” provisions of the Master Settlement Agreement. These provisions require the tobacco companies to pay, from 2008 through 2017, a total of \$861.0 million into the Strategic Contribution Fund. Money from the Strategic Contribution Fund is to be allocated to states based on the percentage each state contributed to the original Master Settlement Agreement. Kansas' share of this amount is 1.85 percent.

The FY 2017 payment included the final year of the five year settlement plan of the disputed payments and the end of the Strategic Contribution Fund payments under the original Master Settlement Agreement. The end of those payments results in a permanent reduction in the annual amount received by the State. Decisions made by tobacco manufacturers will increase the potential for variability in state payments, including the potential that funds will be directed to the disputed payments account.

KANSAS TOBACCO REVENUES AND INTEREST EARNINGS		
FY 1999	\$	49,705,586
FY 2000		52,935,158
FY 2001		61,465,211
FY 2002		61,511,858
FY 2003		52,531,729
FY 2004		53,453,765
FY 2005		49,463,355
FY 2006		47,515,501
FY 2007		46,900,000
FY 2008		66,347,833
FY 2009		72,278,198
FY 2010		60,838,465
FY 2011		57,091,087
FY 2012		57,985,065
FY 2013		68,034,311
FY 2014		62,378,062
FY 2015		62,452,849
FY 2016		59,133,333
FY 2017		62,057,022
FY 2018		57,645,631
FY 2019		55,989,219
FY 2020 (est.)		52,000,000
FY 2021 (est.)		50,000,000

Concern Over Future Payments

The amount of tobacco money the states will receive is affected by several factors, including an overall decrease in tobacco consumption, which results in diminished sales of tobacco products and lower payments to states. The market share of tobacco companies that are participating in the settlement also is being reduced by sales of nonparticipating manufacturers, and the possibility exists that one or more of the major participating manufacturers could declare bankruptcy. The most immediate and direct threat to the tobacco revenue stream is a clause in the Master Settlement Agreement that permits participating manufacturers to seek refund of money paid to the states when there is a drop in their market share below a threshold established in 1997.

That threshold was triggered in 2003, and 2006 was the first year for which revenues were affected. In 2006, R.J. Reynolds Tobacco Company and Lorillard Tobacco Company withheld all or part of their payments to the states, contending that under the Master Settlement Agreement, the payments were not due because of declining market shares. The National Association of Attorneys General, which has played a leadership role among the states with regard to the tobacco settlement, takes the position that the tobacco companies owe the states the full payment until the industry can demonstrate that the states have failed to exercise due diligence in enforcing the tobacco settlement. (*Note:* The settlement is complicated, and there is disagreement between the industry and the states as to exactly how the downward adjustment clause should be interpreted or applied.) In June 2007, the State received \$394,424 in funding from the disputed payments account. In March 2009, the State received \$4.5 million from the disputed payments account.

Kansas Endowment for Youth/Children's Initiatives Fund

The Master Settlement Agreement does not impose any constraints on how the states may use their tobacco money. In Kansas, the 1999 Legislature passed legislation that established a trust fund into which tobacco payments are credited and created the Kansas Children's Cabinet to advise the Governor and the Legislature on programs to be funded from the tobacco money. The trust fund, named the Kansas Endowment for Youth (KEY) Fund, is invested and managed by the Board of Trustees of the Kansas Public Employees Retirement System. The settlement payments are placed in the KEY Fund.

The Legislature also created the Children's Initiatives Fund. The Children's Initiatives Fund is administered by the Children's Cabinet, a 15-member committee consisting of appointees of the Governor and Legislature and ex officio members. The Cabinet is responsible for initiating audits and reviews of the programs receiving Children's Initiatives Fund money. The legislation provided that transfers would be made from the KEY Fund to the Children's Initiatives Fund on an annual basis.

Transfers from the KEY Fund to the Children's Initiatives Fund are set at 102.5 percent of the amount transferred the previous year. Expenditures from the Children's Initiatives Fund are requested by the Children's Cabinet through the State Department of Education, recommended by the Governor, and approved by the Legislature. The Kansas tobacco settlement is the primary revenue source for the Children's Initiatives Fund.

In general, the KEY Fund has not served as the endowment fund that was envisioned. This is attributed to a combination of less tobacco payment revenue than expected and

shortfalls to the State General Fund (SGF), which have resulted in balances in the KEY Fund being transferred to the SGF rather than allowing them to accumulate.

The following chart details transfers from the KEY Fund to the SGF. The transfers in the first two fiscal years were authorized in the 1999 enabling statute, KSA 38-2102. The chart only includes years in which a transfer took place; if there was no transfer from the KEY Fund to the SGF, the fiscal year is not included.

KEY FUND TRANSFERS TO THE SGF		
FY 2001	\$	91,078,133
FY 2002		16,000,000
FY 2003		24,326,752
FY 2004		9,900,000
FY 2005		1,654,514
FY 2006		375,957
FY 2009		4,097
FY 2010		14,291,913
FY 2013		9,500,000
FY 2015		12,000,000
FY 2016		9,578,000
FY 2017		15,616,078
FY 2018		200,000

The following chart details transfers from the Children's Initiatives Fund to the SGF. The chart only includes years in which a transfer took place; if there was no transfer from the Children's Initiatives Fund to the SGF, the fiscal year is not included.

CHILDREN'S INITIATIVES FUND TRANSFERS TO THE SGF		
FY 2003	\$	3,873,144
FY 2004		1,144,144
FY 2005		512,707
FY 2006		2,212
FY 2007		648,789
FY 2009		19,421
FY 2010		20,782
FY 2011		1,463
FY 2014		1,000,000
FY 2015		1,500,000
FY 2016		12,562,625
FY 2017		9,218,834